Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:HMT:[redacted]:1:POSTF-164607-01
[redacted]

date: April 15, 2002

to: [redacted], [redacted], LM:RFPH:[redacted]

from: Associate Area Counsel, (LMSB) [redacted]

subject: [redacted]
Charter Ownership Agreement Income
[redacted]

You recently requested our advice concerning the sale of charter ownership agreements at [redacted] in [redacted]. This memorandum responds to your request. This memorandum should not be cited as precedent. For the reasons described below, we agree that the [redacted] must report as income the amounts received from the sale of the charter ownership agreements.

Issues

1. Must the [redacted] recognize income from the sale of charter ownership agreements at [redacted]?

2. How much income must the [redacted] recognize?

Conclusions

1. The [redacted] must recognize income from the sale of charter ownership agreements.

2. For the year ended February 28, [redacted], the [redacted] must recognize $[redacted] under the accrual method of accounting.

Audit Background

A notice of deficiency will be issued for the shareholders of the [redacted] for the year ended February 28, [redacted], today, April 15, [redacted]. The [redacted] ([redacted]) is an S Corporation. The statute of limitations for the [redacted] tax return already expired, however all the shareholders still have open statutes. The statute of limitations on assessment of an S corporation shareholder's tax liability begins to run when the shareholder's tax return is filed. S.B. Bufferd 93-1 USTC ¶ 50,038. The [redacted] have not elected TEFRA audit procedures. The [redacted]' have [redacted] shareholders, [redacted] shareholders, and [redacted] ([redacted]) as shareholders. All these taxpayers report their distributive share of the [redacted]' income on Schedule E of their respective individual tax returns for the year ended December 31, [redacted]. You have determined that all of these individual statutes will expire on April 15, [redacted].

Earlier this year, you requested statute extensions for these shareholders. You were recently informed that the shareholders would not extend their statutes. The [redacted] have generally stonewalled your information requests. You summonsed information from a bank, the [redacted], and requested information from [redacted], the county in which [redacted] and [redacted] is located. The bank provided the information on [redacted]. The [redacted], through its attorneys, provided sparse information on [redacted]. The [redacted] refused to provide much of the information explaining that it was privileged. [redacted] has agreed to provide the information, but has not yet located the informally requested files. Last week, you met with [redacted] and his accounting assistant. They identified their sales report for the COA sales and assured you of their accuracy. This issue was discovered late in the examination, the [redacted]' shareholders have increased the pressure by not extending the statute, and you are putting the notice of deficiency together at the last minute.

We are conditionally approving issuing the notice of deficiency because of the foregoing events and because we anticipate receiving additional information from [redacted]. That additional information will support the tax computation. We recognize the hazards present in approving a notice of deficiency under these circumstances. However, we also realize that if we do not approve the notice for this year, the [redacted], and their shareholders, would likely escape taxation on a substantial amount of income. Furthermore, [redacted]

Factual Background

The [redacted] own a franchise that plays [redacted] in the [redacted]. The team plays in [redacted], which is located in [redacted]. In the early [redacted]'s, the [redacted] from [redacted] unless [redacted]. For the prior [redacted] years, the [redacted] and the [redacted] shared [redacted]. The [redacted] wanted a new [redacted] that would generate substantial additional income. [redacted] wanted to keep the [redacted] in [redacted] and wanted to fund the stadium project with a combination of public and private funds.

In March, [redacted], the voters of [redacted] approved a [redacted]% increase in the sales tax the proceeds from which were to be used [redacted] ([redacted]). [redacted] would own the [redacted], and the [redacted] would lease them. On [redacted], the [redacted] and [redacted] (the "County") signed a Memorandum of Understanding for the construction of the [redacted] stadium. Eight months later, on [redacted], the [redacted] and [redacted] entered into a Lease Agreement for the new [redacted]. In [redacted], construction on the new [redacted], named [redacted], was substantially complete and the [redacted] in the new facility.

The MOU framed the major components of the "[redacted]". In fact, the MOU and the Lease were the only documents we have located which were signed by representatives of the [redacted] and [redacted]. [redacted] agreed to construct a new [redacted] at a location chosen by the [redacted]. The [redacted] agreed to play their [redacted] there. The new [redacted] would be comparable to new [redacted] in other [redacted] cities. MOU Paragraph 3, Financing and Equity Contributions, sets forth the financing for the [redacted]. Subparagraph A(2) sets forth the [redacted] Contribution as follows, ...

[redacted]

[redacted]

Paragraph [redacted] of the MOU lists the [redacted] that must occur before the [redacted] project would commence. These conditions were a) [redacted], b) [redacted], c) [redacted], d) [redacted], e) [redacted], f) [redacted], and g) [redacted]. Subparagraph [redacted], [redacted], states that "[redacted]

Ultimately, the parties negotiated an arrangement whereby [redacted], not the [redacted], would be responsible for selling the [redacted] licenses. The [redacted] never physically received the funds from the sale of [redacted] licenses, frequently called [redacted] or COAs (charter ownership agreements). The [redacted] facilitated, assisted and cooperated with the sale of the COAs, but all revenue (net of commissions, fees, taxes, and other expenses) went first to an escrow account, a lockbox, and ultimately to [redacted].

Other aspects of the sale of the [redacted] licenses were also negotiated by the parties. On [redacted], [redacted] entered into an agreement with [redacted], Inc. ("[redacted]") for [redacted] to act as an agent to market and sell [redacted] Licenses for [redacted]. The agreement was consistent with the provision of the MOU ...

[redacted]

On [redacted], [redacted] and the [redacted] entered into an Information Access Agreement.

[redacted]

[redacted]

The [redacted] also granted to [redacted] a non-exclusive license to use of the "[redacted]" trademark (the "Mark"). [redacted]'s license to use the Mark expired in [redacted].

Shortly after the [redacted] agreements, [redacted] started a marketing program called "[redacted]" to sell COAs. A [redacted] or COA is a one-time fee paid for the right to buy [redacted] for specific [redacted] for varying term lengths (usually for as long as the [redacted] plays in a specific facility). The COA is transferable by the owner. The COA concept evolved as a way for [redacted] to participate, at least financially, in the building or revival of their own [redacted] and [redacted]. Usually, substantial portions of the proceeds from the sale of [redacted] go to the construction costs of a new facility. The [redacted] concept has been used for all levels of [redacted] facilities, including [redacted], [redacted], [redacted], [redacted]. The [redacted] can be found in nearly every [redacted].

The COA program was marketed to [redacted]' [redacted] as their opportunity to "[redacted]." Only the [redacted]' existing [redacted] were given incentives to purchase COAs. The incentives included a [redacted]% discount on the cost of the COA and priority in [redacted]. These incentives required the [redacted] to maintain the [redacted] until the opening of the new stadium. Current [redacted] were also given the right to purchase [redacted] before the general public and receive priority [redacted]. Current [redacted] could also purchase an unlimited number of [redacted] and maintain the discount and priority incentives for their COA [redacted]. [redacted] did not share in any of the additional [redacted] premiums or revenues, it received only the COA fee.

The Charter Ownership Agreement for [redacted] provides that ...

[redacted]

[redacted]

This agreement was between the [redacted] (Licensee) and [redacted] (Licensor). The amount of the COA payment depended on [redacted]. The better [redacted], the higher the fee. The deferred payment schedule required [redacted] of the fee be paid with the application, a total of at least [redacted] on or before [redacted], and the remaining balance on or before [redacted]. The COA agreement contains a Disclaimer that the Licensee acknowledges that the [redacted] have not made any representations, whatsoever, regarding the COAs. The [redacted] are not a party to the COA agreement, but are a Third Party Beneficiary. The COA agreement also relieves the [redacted] of any potential liability under the agreement. The Licensee expressly agrees not to sue the [redacted] for damages or injunctive relief relating to the COAs even if the [redacted] do not play their [redacted] in the [redacted] or within [redacted]. The COAs do not apply to events other than [redacted]. [redacted] for non-[redacted] events have been and are available from the events themselves, and COA owners have no obligation or right to purchase those [redacted]. COA owners are guaranteed the same [redacted] for every [redacted]' [redacted] played in the [redacted]. Forfeited COAs may be resold by the [redacted] without any compensation to the original purchaser or transferee. [redacted] owner exhibits behavior in the [redacted] that is not acceptable in a family atmosphere as determined by the [redacted], the COA may be forfeited to the [redacted].

The COA fees were as follows:

[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]
[redacted]	$[redacted]

The funds received from the sales of the COAs by [redacted], Inc., dba [redacted], were sent directly to a lockbox at [redacted] Bank. These funds were later transferred into another bank account. Once the lease was signed, the funds were transferred to one of [redacted]'s bank accounts. According to [redacted], all records pertaining to the COA program were turned over to [redacted] at the end of the sales campaign. We requested these documents but have not yet received them. [redacted]

Ultimately, [redacted] received and retained all net revenues from the sale of COAs prior to [redacted]. These funds paid a small portion of the [redacted] construction costs. An amendment to the lease dated [redacted], transferred to the [redacted] the rights to administer the COA program and receive the proceeds of such COA sales made after [redacted]. The [redacted] also took over the "[redacted]" marketing program. The [redacted] then obtained the right to sell and retain all revenues from sales of COAs after [redacted]. [redacted] then gratuitously gave the [redacted] all the computers, software, and associated licenses for the COA campaign. The COA agreement the [redacted] used beginning in the year [redacted] when the [redacted] began selling the COAs is substantially similar to the agreement used by [redacted].

In [redacted], we interviewed [redacted], Administrator for [redacted], to discuss the MOU and Lease Agreement. [redacted] was a somewhat reluctant witness who appeared helpful to the [redacted]. An attorney from [redacted] was present at the interview as well as the [redacted]' attorney, whom [redacted] "invited". [redacted]

[redacted]

At the time of these events, the [redacted] declared that they were [redacted]. The [redacted] publicly stated that they contributed to the construction of the [redacted]. [redacted] the [redacted]'s [redacted]

The VTS Waiver

[redacted] apparently was unaware of or otherwise forgot that the [redacted] and the [redacted] believe they have rights to [redacted] revenues. Concurrent with the Lease agreement, [redacted]

[redacted]

[redacted]

[redacted]

The [redacted] requires certain types of revenue be shared among all the teams. Visiting teams get approximately [redacted]% of these sources of revenues after the games are played. [redacted] sales was $[redacted]. The estimated [redacted] were $[redacted] for [redacted] years. The [redacted] was computed by taking the total lease payments to be made by the [redacted] of $[redacted] and other up-front payments of $[redacted]. These other up-front payments of $[redacted] appear to correspond to the $[redacted] in [redacted] and the $[redacted] per [redacted] surcharge that were listed as components of the [redacted]' contribution to the [redacted] in the MOU of [redacted], with [redacted]. The [redacted] estimated the Total Waiver Request to be $[redacted] ($[redacted] for [redacted] and $[redacted] for [redacted]).

The Lawsuit

Some [redacted] did not receive COAs in [redacted]. Apparently, [redacted] COAs in the more [redacted]

These [redacted] sued [redacted] and the [redacted] in [redacted]. A settlement of the case was entered on [redacted]. Apparently, [redacted] refunded some money to the COA purchasers while the [redacted] provided [redacted] for these [redacted].

The Timeline

A time line might help understand the foregoing events.

[redacted] -- [redacted] voters approve an increase in sales tax to fund [redacted].

[redacted] -- The [redacted] and [redacted] sign a MOU which provides a framework for construction of the [redacted].

[redacted] -- [redacted] begins receiving COA deposits. Approximately $[redacted] is received during the first [redacted] months.

[redacted] -- *Our tax year begins.*

[redacted] -- The [redacted] approves the [redacted] waiver.

[redacted] -- The [redacted] and [redacted] sign a lease for the [redacted].

[redacted] - [redacted]. -- [redacted] receives the second installment payment for the COAs.

[redacted] -- *Our tax year ends.*

[redacted] - [redacted]. -- [redacted] receives the final installment payment for the COAs.

[redacted] -- [redacted] begin selling the COAs.

[redacted] -- [redacted] begin [redacted].

[redacted] -- COA purchasers [redacted]

[redacted] -- [redacted]

Analysis
Is It Income to the [redacted]?

We believe the COA funds are income to the [redacted] based upon well settled principles of income taxation. While the [redacted] negotiated the transaction so that it would not actually possess the funds, the funds are nevertheless income to the [redacted]. Section 61 of the Internal Revenue Code generally defines gross income as "income from whatever source derived", except as otherwise provided by law. Gross income includes income realized in any form, whether in money, property, or services. This definition encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955). Income must be taxed to him who earns it. Commissioner v. Culbertson 337 U.S. 733 (1949).

Section 61 does not determine who is responsible for the tax liability once sums have been identified as income. Generally, the taxpayer who receives the income is taxable on it. However, some sharp taxpayers structure income producing arrangements so that they do not actually receive the income even though they earned the income or otherwise had a right to it. These sharp taxpayers place receipt of the income in a taxpayer who has little or no tax liability or is otherwise indifferent. The [redacted] negotiated an arrangement which places the income in the hands of a governmental entity -- [redacted]. To address this abuse, the Courts have developed the assignment of income doctrine. This doctrine is designed to prevent taxpayers from shifting income to avoid paying federal income taxes. Lucas v. Earl, 281 U.S. 111 (1930); Corliss v. Bowers, 281 U.S. 376 (1930).

In Helvering v. Horst, 311 U.S. 112 (1940), the taxpayer detached interest coupons from bonds, just prior to their due date, and gave them to his son. Although the son collected the interest at maturity, the Commissioner determined that these interest payments were income to the father. The Court held that the father's control and enjoyment of the income sufficed to establish him as the recipient of the income. As holder of the bond and coupons, the father had the legal right to demand payment of the interest at maturity. The Court recognized, as it had in Corliss, that the power to command disposal of income was tantamount to enjoyment of that income.

Our research reveals no case with substantially similar facts as our own. Apparently, all the other [redacted] situations were resolved without a Court opinion. While there are competing theories for income recognition in this case, e.g., constructive receipt, agency theory, we also believe our best argument involves an assignment of income theory.

The [redacted] are an accrual method taxpayer. Section 451(a) of the Code provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for in a different period. Treas. Reg.

§ 1.451-1 provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive the income, and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance takes place; (2) payment is due; or (3) payment is made, whichever happens first. See Schlude v. Commissioner, 372 U.S. 128 (1963), 1963-1 C.B. 99; Rev. Rul. 80-308, 1980-2 C.B. 162; Rev. Rul. 79-195, 1979-1 C.B. 177.

In San Francisco Stevedoring Co., 8 T.C. 222, 225, the Tax Court set forth the principles of law applicable to a determination of the proper accrual of income as follows: A taxpayer, using an accrual method of accounting, must accrue an item in the year in which the taxpayer acquires a fixed and unconditional right to receive the amount, even though actual payment is to be deferred. There must be no contingency or unreasonable uncertainty qualifying the payment or receipt. Income does not accrue to a taxpayer using an accrual method until there arises in him a fixed or unconditional right to receive it.

Income in Which Year?

We have chosen to adjust the [redacted]' income for the year ended [redacted], primarily because during that fiscal year the [redacted] and [redacted] signed the Lease Agreement. While the COA sales program began in late [redacted], substantial contingencies in the project existed until the lease was signed on [redacted]. Until all conditions precedent were met, there was a possibility [redacted] would not be constructed and the COA deposits would be refunded.

The MOU of [redacted], set out the proposal for the [redacted] project including financing. The MOU specifically stated [redacted]. The $[redacted] was to be comprised of net revenue from the sale of [redacted] licenses, a portion of the [redacted], lease payments and $[redacted] per [redacted]. With the exception of the yearly rent payments, none of the other items required an outlay of cash from the [redacted]. Even though the sale of the COAs did not require an outlay of cash from the [redacted], [redacted] would have not been able to sell COAs without the [redacted] allowing them to sell them.

Before the [redacted] could enter into the lease with [redacted], they had to obtain permission from the [redacted]. The [redacted] gave that permission in [redacted], a date within the [redacted]'s [redacted] fiscal year. The [redacted] indirectly approved the MOU with this resolution. The [redacted] obtained the necessary waiver for nonsharing of the COA income and [redacted] with visiting [redacted] teams during our year. It is no coincidence that these [redacted] granted waivers and other items coincide with the amount of the contribution due from the [redacted] under the MOU.

How much Income in Our Year?

We note that for the [redacted] who subscribed to the original COA agreement, payments for the COAs were made over a [redacted] year period: [redacted]; [redacted]; and [redacted]. Most of the COA purchasers used this deferred payment option. Some [redacted], however, paid for the COAs in 1 lump sum payment. When we identified those amounts, we eliminated the "lump-sum" purchases made after [redacted]. Those purchases are income to the [redacted] in later years. For lump sum payments made in a prior year, we still believe that [redacted], is the appropriate year for reporting the income because that is the year the lease was signed.

While we must issue the notice of deficiency for the [redacted]' year ended [redacted], at this time, we have additional time to issue a notice of deficiency for the [redacted]' subsequent years. If we have included this income in the wrong year, we can fix that. This is the only issue on the current notice of deficiency. Because the [redacted] did not include the income from the COA sales, the [redacted] did not seek to write off any expense or amortize any asset when the funds were turned over to [redacted]. This notice of deficiency does not and need not determine the appropriate write off of these amounts by the [redacted].

Conclusion

The proceeds from the sale of the Charter Ownership Agreements (COAs) are taxable income to the [redacted] in the fiscal year ended [redacted]. The [redacted] assigned their right to receive this income to [redacted] as their contribution for the lease of [redacted] as stated in a Memorandum of Understanding (MOU) dated [redacted]. The [redacted] used the accrual method of accounting to recognize income and expenses. In accordance with IRC §451, the COA income would not have been accruable by the [redacted] in fiscal year ended [redacted], because their right to the income was not fixed due to contingencies. When the [redacted] signed the lease in [redacted], the majority of the conditions had been satisfied. Therefore, the [redacted]'s right to the income accrued during the year ended [redacted].

If you have any questions about this memo, please contact [redacted] at [redacted]. A copy of this memorandum will be sent to our national office for a 10 day post review.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

[redacted]
Associate Area Counsel (LMSB)

By:____________________________
[redacted]
Senior Attorney (LMSB)